

TECHNICAL ASSISTANCE AND TRAINING NEEDS ASSESSMENT FOR FINANCIAL INSTITUTIONS

**FINANCIAL MARKETS PROJECT, SRI LANKA
(USAID Contract No. 383-0100-C-00-3063-00)**

**By
Bradford A. Warner, Jr.
Vice President, Private Enterprise and Economics, ISTI**

February 1994



International Science and Technology Institute, Inc.

Financial Markets Project (FMP), funded by the United States Agency for International Development, is designed to improve the reliability of capital market information, increase the availability of financial instruments and assist the development of new forms of financial intermediation in Sri Lanka. It began activities in the field and will continue till the end of 1995. The project will assist in the development of the Securities and Exchange Commission (SEC), Colombo Stock Exchange (CSE), Institute of Chartered Accountants, the Central Bank and emerging financial institutions and will institute the Chartered Financial Analysts training program and assist with the development of a secondary debt market for government and corporate obligations.

The FMP Series.

This series presents research studies, reports, discussion papers and notes prepared by experts working on assignments for the project.

1. *Debt Securities Action Plan*. Michael BeVier and John Biasucci, Chairman and President, respectively, of MorBanc Financial Corporation. September 1993.

2. *Recommendations and Activity Report Training Courses for financial Journalists and Seminars for Policy and Opinion Makers*. Hannan Ezekiel, Senior Economist, ISTI. October 1993.

3. *1993 Securities Regulation in Sri Lanka*. Robert Bishop, retired Chief Regulatory Officer New York Stock Exchange. The report examines the progress made by the SEC and CSE in implementing regulatory changes, many which were proposed by Mr. Bishop during an assignment for ISTI in 1990. Provides commentary on progress since 1990 with discussion and recommendations on 18 areas for current attention. November, 1993.

4. *Legislative Review and Training*, Jeswald Salacuse, Dean and Henry J. Braker Professor, and Joel Trachtman, Associate Professor, Fletcher School of Law and Diplomacy, Tufts University. The report analyzes Sri Lanka's legislative and training needs with respect to securities and financial markets. December, 1993.

5. *Technical Assistance and Training Needs Assessment for Financial Institutions*. Bradford A. Warner, Jr., Vice President, Private Enterprise and Economics at ISTI. This study identifies needs for technical assistance and training to selected emerging financial institutions to improve their analytical capabilities and presents a number of research and policy issues which arose during the course of the field visit.

Forthcoming

Stock Option Plan Study, Khursheed Choksy with Robert Bishop. This study examines issues related to developing stock options and compensation for senior corporate executives. January, 1994.

Second-Tier Market Research Study, Khursheed Choksy, Research and Operations Manager FMP, and Bradford Warner, Vice President, Private Sector and Economics at ISTI. This study examines the motives and constraints under which Sri Lankan companies decide to raise equity through public share offerings and the potential for a second-tier market. January 1994.

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I. INTRODUCTION AND SUMMARY

A. Introduction

As outlined in the Annual Work Plan, one of the targeted activities of the Financial Markets Project (FMP or Project) is to improve the analytical capability of market participants by providing technical assistance and training to selected emerging financial institutions to encourage innovative new activities in the field of financial markets and, thereby, improve their functioning.

The broad objective of this technical assistance and training is to strengthen the domestic institutional foundation of the capital market and the role that these institutions can play in the further development of the capital market. In addition, the technical assistance and training will seek to further develop financial instruments on behalf of the institutions assisted.

It is envisaged that such assistance will be based on requests from the recipient institutions and that they will bear at least 25 percent of the costs of any technical assistance contracted. These costs are defined to include a consultant's daily rate, international travel and per diem but *excludes* ISTI's overhead. The cost sharing feature provides a means for the sustainability of future training. The technical assistance and training requests must be approved by the USAID Project Officer. This approval is to be evaluated on the basis of the requests' contribution to the overall Project purposes which are to: develop the capacity of the capital market to broaden public equity participation in the economy; and to increase capital resources for investment. The level of effort specified in the contract, as amended, for this component is 14-person months.

B. Summary

Mr. Bradford A. Warner, Jr. (hereafter referred to as the consultant), Vice President, Private Enterprise and Economics Division, ISTI, performed the Needs Assessment in Colombo, which began December 8, and concluded on December 22, 1993. During that period, the consultant held a total of 33 meetings covering 30 institutions. In addition, the consultant met with USAID for orientation on December 8 and presented a wrap-up briefing on December 22 to interested USAID Mission personnel.

This report is organized into four sections as follows, plus appendices:

- I. Introduction and Summary
- II. Needs Assessment
- III. Cost-Sharing and Operating Methodology
- IV. Research and Policy Issues Identified

A summary of each of these sections is presented below.

- **Needs Assessment:**

The findings of the Needs Assessment identified some 40 technical assistance and training needs expressed by approximately 20 different types of institutions. During the course of discussions with the institutions, approximately 20 additional research or policy issues were identified which could be examined utilizing the research capability of the Project.

The technical assistance and training needs have been consolidated and grouped into three categories; key widespread needs; key narrow focus needs; and other specialized needs. Whenever possible, the training envisioned is targeted at mid-level management. A Needs/Institutions matrix summarizing these categories is set forth on the following page.

NEEDS INSTITUTIONS MATRIX

Type of Institution Technical Assistance Needs	Unit Trusts	Underwriters	Insurance Companies	Retirement Funds	Investment Trusts	Venture Capital Companies	Brokers	Merchant Banks	Non-Bank Primary Dealers	Commercial Banks	Major Industrial Companies	Securities Dealers	Colombo Stock Exchange	Securities and Exchange Commission	Development Finance Institutions	Law Firms	Accounting Firms	Venture Capital Investees	Remarks
1. Widespread Needs																			
Mid-level courses on Portfolio Management and Securities Analysis	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	*Venture Capital and Accounting -- Valuations, Non-bank primary dealers and commercial banks -- debt portfolios, CSE, SEC, Law Firms for information
Initial Public Offering Training on Due Diligence, Valuation, Documentation, Analysis of the Prospectus	x	x	x	x	x	x	x	x		x	x	x	x	x	x	x	x	x	
Documentation of Financial Instruments	x	x	x	x	x	x	x	x		x	x	x	x	x	x	x	x	x	
Seminars to describe each type of financial institution and financial instrument	x	x	x	x	x	x	x	x		x	x	x	x	x	x	x	x	x	
Establish National Securities Analysts' Society	x	x	x	x	x	x	x	x		x	x	x	x	x	x	x	x	x	
2. Narrow Focus Needs																			
Training Traders							x	x	x			x							
Unit Trust Association - Public Awareness Campaign	x																		
Company Treasury Operations								x		x	x								
Brokers - Series 7 upgrade, Series 8 and Brokers Needs Assessment							x												
Venture Capital Investing and Company Finance		x				x	x	x					x	x		x	x	x	Training in identification of investment opportunities, evaluation, negotiation, financial structuring, monitoring and exiting. Training in corporate finance, mergers and acquisitions and financial restructurings
3. Other Specialized Needs																			
Develop New Instruments	x		x	x				x		x	x					x	x		Annuities, factoring, commercial paper, Negotiable Bank C/Ds, cash flow lending, money market unit trusts
Strategic Planning													x						
Insurance Industry Assistance			x																
Self-Regulatory Functions and responsibilities							x						x	x					Training of representatives, SAARC - SAHA, Reinsurance, Foreign Training
Generic Investing Booklets							x						x	x					

-- **Widespread Needs**

- Focused mid-level courses on Portfolio Management and Securities Analysis.
- Initial Public Offering training: Due Diligence, Valuation, Documentation and Analysis of the Prospectus.
- Documentation of Financial Instruments: Provide standard model documentation (off the shelf from developed markets) for debt and equity instruments; hold workshop on the legal and financial mechanics involved in financial transactions.
- Seminars to describe the functions of each type of financial institution and financial instrument.
- Establish an Association of Securities and Investment Analysts.

Potential participating institutions for these widespread needs would include:

- Accountants
- Brokers
- Colombo Stock Exchange (CSE)

- Commercial Bankers
- Development Finance Institutions
- Insurance Companies
- Investment Trusts
- Large and mid-size Companies
- Lawyers
- Merchant Bankers
- Non-Bank Primary Dealers
- Provident Funds
- Securities and Exchange Commission (SEC)
- Securities Dealers (when they come into existence)
- Underwriters
- Unit Trusts
- Venture Capital Companies
- Venture Capital Company Investees.

-- **Narrow Focus Needs**

- Training Traders: Debt-Non-Bank Primary Dealers; Equity - Securities Dealers.
- Unit Trust Association: design public awareness campaign.
- Company Treasury Operations: cash management, commercial paper and cash flow lending.

- Brokers: upgrade Series 7, develop Series 8 and provide operational and sales support training as identified in the Project's Training Manager's report on Stock Brokerage Needs Assessment. (Attached as Appendix 4.)
- Venture Capital Companies and certain other primary market investors: training in identification of investment opportunities, evaluation, negotiation, financial structuring, monitoring and exiting; training in corporate finance, mergers and acquisitions and financial restructuring.

The other specialized needs include: assistance in the development of several new instruments: annuities, factoring, negotiable bank C/Ds, and money market unit trusts; strategic planning; insurance industry assistance; self-regulatory organization functions and responsibilities; and the development of generic booklets for the investing public.

- Cost-Sharing

The cost-sharing feature of this activity provides the means for the future sustainability of the training initiatives of the Project. In essence, this cost-sharing provides additional resources which can be utilized for additional training in the Chartered Financial Analysts (CFA) Program and for other industry associations either already in existence or to be formed.

USAID's Regional Legal Officer has been consulted on this issue on a preliminary basis. This consultant's recommendation would be to establish an ISTI-managed program to properly channel these additional resources for Project purposes.

■ Operating Methodology

The Chief of Party should be responsible for: 1) obtaining USAID's approval of the overall planned activities and, subsequently, notification to the Securities and Exchange Commission and the Colombo Stock Exchange; 2) soliciting requests from institutions in the preapproved activities and assisting the institutions in fashioning such requests, including their respective cost-sharing contribution; 3) submitting the requests to USAID and obtaining its approval; 4) initiating Scopes of Work for the technical assistance and training to be provided; and 5) management and supervision of the implementation of the requested technical assistance and training, including the cost-sharing arrangement.

■ Research and Policy Issues Identified

During the course of discussions with the institutions, the following potential research or policy topics were identified:

- Private placements prior to a public offering: Determine the need to regulate and ascertain whether prevailing regulatory jurisdiction is appropriate;

- Identify the participants, and extent and composition of the private provident fund portfolios;
- Examine the feasibility of removing the restriction on sale of Unit Trust securities to non-nationals;
- Examine the rationale for including assumed future brokerage commissions in the spread between a Unit Trust Manager's buying and selling price;
- Examine the extent of abuses in the allocation of shares of companies being privatized whereby an employer uses his employees' allocation for himself;
- Explore improvements to the Initial Public Offering process; enhance the ability of institutional investors to participate, explore the possibility of allowing Unit Trusts to substitute for vast numbers of individual investors with uneconomically small holdings.
- Examine the original objectives of the Employees Trust Fund, Employees Provident Fund and the National Savings Bank; to what extent are these objectives being carried out or are they still relevant? (USAID had earlier commissioned Louis Berger to do such a report on the Employees Trust Fund [circa 1987-88]). Explore feasibility of "freeing-up" new provident funds rather than continue with the Employees Provident Fund and Employees Trust Fund; Explore feasibility of placing the Employees Provident Fund and Employees Trust Fund under private management;
- Assess the Insurance Companies regulatory climate;
- Develop a position on the feasibility of introducing options, stock index futures and securitized financings;

- Review the lien registration process and examine the feasibility of automating the process;
- Review the taxation of financial instruments (including annuities) and institutions such as provident funds. Look at the effect of such taxation on the primary and secondary markets and on monetary policy.
- Review the proposed changes to the Companies Act; (Obtain Chamber of Commerce analysis.)
- Review the need for specific leasing regulations or legislation;
- Review the status of the agents for Unit Trusts; for example, Peoples Bank branches acting as agents for National Asset Management Ltd. (NAMAL). Have these agents been licensed?
- Review the trading rule requiring a broker's personal trades to be executed through a firm other than his own; Review the prohibition on a brokerage firm executing orders for the purchase or sale of securities of affiliates of the brokerage firm;
- Explore whether there should be a minimum educational requirement for brokers;
- Review the dissemination of Colombo Stock Exchange Rules and the consistency of application of those rules; Examine the extent of liability for all the parties in a securities transaction;
- Explore ways to ensure that Annual Reports are filed on time.

II. NEEDS ASSESSMENT

A. Widespread Needs

The widespread needs identified include the following professional areas in which training should be targeted at mid-level management whenever possible. The Needs\Institutions Matrix (Appendix 4) indicates which institutions would particularly benefit from the training provided.

■ Focused mid-level courses on Portfolio Management and Securities Analysis:

There is a wide gap between the level of training provided for Portfolio Management and Securities Analysis under the Series 7 (including the revised version) and the CFA program. The intent here should be to partly fill that gap with practical but comprehensive courses and materials covering the following areas:

-- Portfolio Management

-- Debt

-- Equity

-- Securities Analysis

-- Debt

-- Equity

As the Needs\Institutions Matrix (Appendix 4) shows, virtually all types of financial institutions could benefit from this training. The debt content of the Portfolio Management and Securities Analysis training should be particularly relevant to non-bank primary dealers and commercial banks. Both venture capital companies and accounting firms would benefit from exposure to the valuation of equity securities. The Colombo Stock Exchange, the Securities and Exchange Commission and law firms should find this training useful from a general orientation and information vantagepoint.

A two-to three-week (evenings and weekends) home instruction coupled with limited classroom instruction is envisaged for delivery of the courses. Course materials would need to be developed which could be derived from a condensed version of some of the CFA materials or a specially tailored set of materials. Potential sponsoring organizations: Sri Lanka Association of Securities and Investment Analysts (to be formed) in conjunction with the Chartered Financial Analysts Program.

■ Initial Public Offering Training: Due Diligence, Valuation, Documentation and Analysis of the Prospectus:

A recurrent theme during the consultant's interviews was the need for the parties to an offering (from both the offeror's and the offeree's perspective) to fully understand the fundamentals of the public offering process: full disclosure of all material information and the due diligence required to evidence that reasonable efforts have been undertaken to ensure that full disclosure has been made; the valuation process, earning potential, financial condition, return to the investor, market comparables; documentation of the offering and presentation of information in the prospectus

together with liability arising from misrepresentation; and developing a critical framework to analyze the information contained in the Prospectus, from an investor's viewpoint.

A two-to three-week course which would include weekday evenings and weekends is envisaged. Course materials would need to be developed. The U.S. SEC is a good source of such information which would then be customized for the Sri Lankan context. Potential sponsoring organizations: Sri Lanka Share Brokers Society (to be formed), Merchant Bankers Society (to be formed).

- Documentation of Financial Instruments: This need is widespread and applicable to all parties to financial transactions. Model legal agreements, for both debt and equity financings, would be sourced from developed markets and used as training tools for workshops in legal and financial mechanics of offerings. This may be an area in which the Sri Lanka Bar Association could be involved in conjunction with expatriate technical assistance. The audience could be all parties to a securities offering. A weekend workshop for professionals (both legal and investment) is envisaged. Sponsoring organization: Sri Lanka Bar Association.

- Seminars to describe the functions of each type of financial institution and financial instrument:

Here the focus should be on improving the professionalism of market participants through an improved understanding by institutional investors of the intermediaries with whom they will interact and the financial instruments available or to be available. While the target audience would be institutional investors, some regional dissemination may be desirable, e.g., Kandy and

Galle. A sponsoring organization(s) needs to be identified. One day, (Saturday or Sunday seminars are contemplated.

- Establish an Association of Securities and Investment Analysts (ASIA):

There are a small but growing number of securities analysts in Colombo which should be encouraged to form a professional society. Technical assistance is available to organize such an effort and to develop established links with such organizations in other markets. The existence of such an organization coupled with the work of the Chartered Financial Analysts Program enhances the integrity of the market and furthers its development. The sponsoring organization could be the incipient ASIA/SL. Sustainability of the CFA program could be assured through such an organization receiving wider sponsorship from the financial and business community, which employs more than 90% of the CFA aspirants.

B. Narrow Focus Needs:

Narrow focus needs tend to involve fewer industry subsectors than the widespread needs but are important to the development of the institutional capability of the capital market.

- Training Traders:

Here we envision assistance to non-bank primary dealers in government securities, initially Treasury Bills, and securities dealers (as they become authorized). The non-bank primary dealers identified are: John Keells, the Merchant Bank of Sri Lanka and Vanik. It may be desirable to

also include other Primary Dealers, the Foreign Exchange Club and Money Market Traders. Training would include tailored programs for 1) senior management; 2) middle management; and 3) portfolio managers and traders. The portfolio managers could participate in a mid-level course on Portfolio Management listed in A. above. Traders could be exposed to bourse games which have been previously identified by the ISTI debt market team.

It is the consultant's understanding that securities dealers are likely to be permitted in the near future. As a result, the Financial Markets Project should prepare the groundwork necessary to provide appropriate training to securities dealers.

■ Unit Trust Association — Public Awareness Campaign

Unit Trusts should be an important building block for a Capital Market since they are a vehicle designed principally to enable small investors to advantageously participate in the market by offering diversification of risk and professional investment management. However, due to fiscal incentives, primarily, the inception of the Unit Trust industry, late 1991-early 1992, saw large and corporate/institutional investor participation. The Unit Trust Association is concerned that when the fiscal incentives are exhausted, late 1996— early 1997, the large investors will withdraw their funds and the industry, as a whole, will shrink.

In order to forestall such an eventuality, the Unit Trust Association would like to mount a "back to basics" public awareness campaign which would emphasize small and medium-sized individual investors in the rural areas as well as target small- and medium-sized investors in the major cities. By this means as well as Unit Trust specific direct marketing, the Unit Trust Association would

build up the numbers of individual investors and funds under management. The technical assistance to be provided should focus on the design of such a campaign. The actual implementation costs such as advertising and T.V. expenses would be borne by the Unit Trust Association. Approximately two to three weeks of technical assistance is envisaged for this task.

■ Company Treasury Operations

The major companies may well benefit from technical assistance in the general area of treasury operations; namely, how a company manages its short-term cash needs or surpluses. At present, the beginnings of a commercial paper market, or equivalent, are starting to emerge. Commercial paper is a means by which major companies can manage their cash needs or surpluses. Commercial paper is a short-term obligation of a company which, typically, is purchased by another company having surplus funds. In order to make the paper palatable to investors (companies in a surplus cash position) bank guarantees may be used to back-stop the paper. Hence the technical assistance should extend to the commercial banks as well as to the major companies. In addition, merchant banks could be involved as arrangers of commercial paper programs and initiators of secondary market operations in commercial paper.

The implementation of more rigorous accounting practices and auditing standards should enhance the ability of major companies to issue commercial paper. Ultimately, unsecured cash flow lending practices could hence become more widespread.

Possible sponsors could be an association of merchant bankers or the Bankers Association. A weekend seminar for company treasurers, commercial bankers, and merchant bankers is envisaged.

- Brokers: The original Brokers competence course (hereinafter referred to as Series 7) served its purpose well but is now in need of significant revision and updating as a result of developments in the market since it first appeared in June 1992. ISTI consultant, Mr. John Buehler, is currently (late February 1994) in Sri Lanka performing these revisions and updates. Similarly, the need for a branch officer qualifying examination (hereafter referred to as Series 8) has arisen and is being addressed by Mr. Buehler. In the process, most of the issues raised in the ISTI Training Specialist's Report, Stock Brokerage Needs Assessment dated July 14, 1993 (Appendix 3) are being addressed.
- Venture Capital Companies and Certain Other Primary Market Investors: The needs expressed were for the provision of technical assistance in venture capital investing and company finance. Specifically, identification and evaluation of investment opportunities, negotiation--convincing the potential investee that the investor is the right party; monitoring--becoming a partner in the management of the investee and recognizing the potential need to actively manage an investee; exiting the investment--public offering, sale or merger--recognizing the inherent problems of a minority holding in a private company. A related area includes orientation training for investors to go public so that the advantages and disadvantages are objectively disseminated. Other needs expressed were: basic training in company finance and capital structuring/restructuring. Finally, techniques of mergers and acquisitions need to be disseminated in order to provide the investor and investee with exit strategies other than public offerings.

Groups which would benefit from this technical assistance are: underwriters, venture capital companies, brokers, merchant banks, development finance companies, law firms, accountants and venture capital investees. A weekend workshop is envisioned with sponsorship by the Venture Capital Association.

C. Other Specialized Needs:

The other specialized needs for technical assistance which were identified included the following:

■ New Instruments

- Annuities: Annuities typically are structured as level payment plans in which, in return for an initial principal investment, the principal and a contractual interest return is paid on regular periodic basis. The fiscal treatment of such instruments needs to be reviewed (see Research Policy, Issues identified) in order to enhance their marketability.
- Factoring: Factoring involves the pledging, or sale with or without recourse of accounts receivable. The industry is just beginning and could provide a useful additional source of financing to companies.
- Negotiable Bank Certificates of Deposit: Negotiable Bank C/Ds (institutional sized minimum denominations and transferrable) might form a private sector parallel along with commercial paper (see above) to the secondary market for Treasury Bills.

- Money market unit trusts: As of year-end 1993 Treasury Bills were yielding substantially more than deposit accounts offered by the commercial banks. However, the issuing arrangements for Treasury Bills were not utilized by retail investors in general. It may be possible to successfully introduce Money Market Unit Trusts which would invest only in Treasury Bills and would return a yield to the investor superior to that available from bank deposits. Note that disintermediation of banks is likely to occur from Money Market Unit Trusts.

- Asset-backed securities: Asset-backed securities or securitized financings are a subject covered under *Research and Policy Issues Identified*. Typically, financial assets such as mortgage loans, credit cards or lease receivables are pooled and shares or partnership interests in the pool are sold to investors. However, until a more viable primary market for the obligations of such specialized institutions such as the Housing Development Finance Corporation (HDFC) and the National mortgage Bank (NMB) is developed, together with an appropriate yield curve, it is hard to see how the market for securitized financings per se is likely to become viable.

III. COST-SHARING AND OPERATING METHODOLOGY

A. Cost-Sharing

The cost-sharing feature conceived for the provision of technical assistance to emerging financial institutions provides the means for the future sustainability of the training initiatives of the FMP. It is proposed that 25% of the cost of a consultant's daily rate, international travel and per diem, but excluding ISTI's overhead, would be borne by the recipient institutions. These funds would be managed by ISTI, subject to USAID approval, so as to continue selected training initiatives such as the Chartered Financial Analysts Program. The specifics of accounting for and custody of these funds would be negotiated and determined by ISTI and USAID, subject to final approval by USAID.

B. Operating Methodology

The contract calls for all technical assistance and training requests to be approved by the USAID Project Officer, whose approval is to be evaluated on the basis of the requests' contribution to the overall Project purposes of developing the capacity of the capital market to broaden public equity participation in the economy and increase capital resources for investment. The level of effort specified, per modification 3, for this activity is 14-person months.

The Chief of Party should be responsible for: 1) obtaining USAID's approval of the overall planned activities and, subsequently, notification to the Securities and Exchange Commission and the Colombo Stock Exchange; 2) soliciting requests from institutions in the preapproved

activities and assisting the institutions in fashioning such requests, including their respective cost-sharing contribution; 3) submitting the requests to USAID and obtaining its approval; 4) initiating Scopes of Work for the technical assistance and training to be provided; and 5) management and supervision of the implementation of the requested technical assistance and training, including the cost-sharing arrangement.

IV. RESEARCH AND POLICY ISSUES IDENTIFIED

- Private Placements prior to a public offering:

During the latter half of 1993, a number of private placements were transacted prior to an Initial Public Offerings by the same issuers. The SEC has been attempting to include private placements within its jurisdiction rather than under the Registrar of Companies per existing legislation under the Companies Act. Ideally, as has been recommended by ISTI and the Asian Development Bank (ADB), all securities offerings should be under the regulatory jurisdiction of the SEC. In order to improve regulation, and to prevent potential abuse which could arise from the existing legislation, it would be wise to explore the possibility of having a specialized statutory body, the SEC, take over the issuance of securities.

- Identify the participants, extent and composition of the private provident fund portfolios:

The private provident funds should represent an important element in the development of a strong capital market. However, little information is really available on the extent of these activities. This information would be useful to help guide any technical assistance or legislative changes which might facilitate the private provident funds' role in the development of the capital market.

- Examine the feasibility of removing the restriction on the sale of Unit Trust Securities to non-nationals:

The Unit Trust fund managers interviewed felt that this restriction was hurting the growth and development of unit trusts. There are a number of tax, foreign exchange and macro economic (level of interest rates) issues to be addressed in this arena. Due to the paucity of Sri Lanka country funds, one as of December 1993, foreign individual investors have difficulty accessing the Colombo market on a pure play basis, as they are not able to purchase unit trust securities.

- Examine the rationale for including assumed future brokerage commissions in the spread between a Unit Trust Manager's buying and selling price:

The consultant was informed by the unit trust managers interviewed that a unit trust investor's investment is reduced by the following front end fees:

Front End Load	-	5%	
Business Turnover Tax	-	1%	
Assumed Brokerage	-	3%	(Depending on the mix between shares
		—	and debt securities)
Total		<u>9%</u>	

The reduction of the unit holder's investment by an assumed brokerage charge is contrary to conventional practice elsewhere. In the U.S., for example, brokerage fees on the purchase of a share incurred by a mutual fund (equivalent in corporate form to a Unit Trust) would become

part of the cost of that share. When the share was later sold by the fund, the net realized gain or loss (which would include the effect of both of buying and selling commissions) would be reflected in an increase or decrease in net assets.

- Explore Improvements to the Initial Public Offering Process:

One of the most important economic objectives of a capital market is to facilitate capital formation and, hence, economic growth. Several aspects of the current IPO process should be reviewed for possible improvements:

- Enhance the ability of institutional investors to participate.
- Explore the possibility of substituting Unit Trusts for large numbers of small individual investors.
- Examine the extent of abuses in the allocation of shares of companies being privatized whereby an employer uses his employees' allocation for himself. There may be similar abuses in non-privatization IPOs.

- Examine the original objectives of the Employees Trust Fund (ETF), Employees Provident Fund (EPF) and the National Saving Bank (NSB):

- Are these objectives being carried out; are they still relevant?
- Would private sector management be feasible or desirable?
- Could new provident funds be "freed-up" to perform the original objectives of the ETF, EPF, and NSB?

- Review the Insurance Company regulatory climate:
 - Examine the constraints on real estate lending/investment and investment in company debt and equities under the new law.

- Develop a position on the feasibility of introducing exchange traded options, stock index futures and securitized financings:
 - Determine liquidity parameters for the underlying markets, e.g. specific company shares, the shares comprising the components of the index and the primary market for obligations of specialized institutions which could offer securitized financings such as the HDFC.

- Review the lien registration process and examine the feasibility of its being automated:

- Review the taxation of financial instruments (including annuities) and institutions such as pension funds. Look at the effect of such taxation on the primary and secondary markets and on monetary policy:
 - Some of the benefits of the 1990 tax liberalization efforts may be in the process of being reversed: e.g., Business Turnover Tax and Stamp Duty.
 - The consultant was informed that the entirety of a periodic payment received from annuity was taxable as income. This treatment ignores the fact that a portion of the payment is a return of the principal amount (purchase price) of the annuity and is not income.

-- In a number of other countries, Provident Funds are not taxable entities. Only distributions from the fund to the recipient are taxable.

- Review the proposed changes to the Companies Act with reference to the further development of the capital market:

-- See comments of the Chamber of Commerce Analysis. Does the Companies Act need to be further revised to allow for a SEC which has regulatory authority over the issuance and trading of securities, whether listed or unlisted?

- Review the need for specific leasing regulations or legislation:

Leasing can serve as a useful capital market development tool since it can provide medium-term credit to smaller and medium-sized entities. Is the current regulatory, legislative and fiscal climate appropriate to the development of full payout and operating leases?

- Review the status of agents for Unit Trusts:

The consultant was informed that the branches of Peoples' Bank are acting as agents for NAMAI.. There may be other such arrangements. Have these agents been licensed via the Series 7 training and examination? If not, should not they be required to become licensed within a prescribed period of time?

- Review rules on proprietary trading and client executions of orders for securities of affiliates:
 - The prohibition against a broker executing his own trades through his own brokerage firm is contrary to well established practice in the U.S. In the U.S., a broker must execute his own trades through his own brokerage firm and may not have a brokerage account in another firm without his employer's permission. If permission is granted, any activity in that external account must be reported to the broker's employer. The purpose of this arrangement is to prevent abuses such as front running, ramping and trading on inside information by making the brokerage firm responsible for the actions of its employees. Every trade ticket of a brokerage firm is reviewed by a senior official. Examine the rationale for the existing CSE rule in today's climate.
 - The consultant was informed that the prohibition against brokers executing client orders for shares of affiliates was an unnecessary curtailment of business. Examine the underlying rationale for this rule.
- Explore whether there should be a minimum educational requirement for brokers:
 - The consultant was queried whether there should be a minimum educational requirement for brokers. This consultant's reaction is that brokers should be well trained and licensed rather than be subject to an educational requirement. Review this issue and examine practices in other developed and emerging markets.

- Review dissemination of the Colombo Stock Exchange Rules:

To the consultant's knowledge, the dissemination and consistent application of the CSE Rules has been an on-going problem. The lack of dissemination and the inconsistent application of the rules undermines the integrity of the market. In addition, complaints have been vocalized as to the definition of the extent of liability for the parties to a securities transaction. Examine these issues.

- Lateness of Annual Reports:

The consultant was informed that annual reports are frequently filed after the due dates established by the Rules of the Colombo Stock Exchange. This practice undermines the integrity of the market but can be difficult to police unless the CSE is prepared to effectively fine the companies or the directors of the companies involved. Examine this issue.

SCOPE OF WORK
TECHNICAL ASSISTANCE AND TRAINING NEEDS ASSESSMENT
FOR
FINANCIAL INSTITUTIONS

Introduction

Under the contract, one of the targeted activities of the Financial Markets Project (FMP) is to "improve the analytic capability of market participants by: . . . providing T.A. and training to selected emerging financial institutions--to encourage innovative new activities in the field of financial markets and thereby improve its functioning." Such emerging financial institutions may include unit trusts, insurance companies, pension funds, venture capital companies, investment banks and brokers that are becoming active in new market segments. The contract calls for an anticipated 14-person months of short-term expatriate technical resources for training and technical assistance in this component.

The focus of this technical assistance and training should be on the financial market activities of these institutions and their role in the development of Sri Lanka's capital market system. In addition, the technical assistance will seek to further develop financial instruments on behalf of the institutions assisted. It is envisaged that such assistance will be based on requests from the recipient institutions and that they will bear at least 25 percent of the total costs of any technical assistance contracted.¹ Such requests must be approved by the USAID Project Office, which will be evaluated on the basis of their contribution to the overall purpose to develop the capacity of the capital market to broaden public equity participation in the economy and increase capital resources for investment.

Scope of Work

Mr. Bradford A. Warner, Jr., Vice President, Private Enterprise and Economics Division will perform a Technical Assistance and Training Needs Assessment for this component of the FMP. Mr. Warner's tasks are to:

- Identify which financial institutions should be primary users of the technical assistance in order to maximize on the widest feasible audience and have the greatest impact on the market. The identification process will include consultation with the SECSL, CSE, USAID, and the ISTI team. An initial listing of institutions would include:
 - Unit Trusts
 - Underwriters
 - Insurance Companies
 - Retirement Funds
 - Smaller Merchant Banks
 - Investment Trusts

¹ T/A costs to be shared (25%) by local institutions will include consultants' international travel, daily rate and per diem, but not ISTI's overhead.

- Venture Capital Companies (IPO strategies only)
- Brokers

- Ascertain and prioritize the needs of these institutions through interviews with relevant personnel in the institutions.
- Group the institutions and types of technical assistance and training needed into categories suitable for multiple lot treatment. As an example, several groups of institutions may need technical assistance and training in:

- Securities Analysis
- Portfolio Management
- Merchant Bank Management
- Initial Public Offering Strategies

- Coordinate these needs with other long-term technical assistance to the financial sector from, for example, the Asian Development Bank or World Bank so that the efforts are complementary.
- Outline the requirements and brief USAID, SECSL, CSE, ICASL and the ISTI team before departure.
- By January 10, 1994 issue a final report from ISTI Washington which can be used as a guide by the Chief of Party to develop specific requests from institutions.

Schedule and Level of Effort

The total days of labor for the Technical Assistance and Training Needs Assessment is approximately 19 work days comprising 12 days in country, 4 days in ISTI Washington for subsequent report writing and 3 travel days. Mr. Warner will begin not later than November 29. While in country, Mr. Warner will report to Mr. Gibbs Macdaniel, Chief of Party.

LIST OF INSTITUTIONS AND PERSONS INTERVIEWED

Counterpart Organizations

- United States Agency for International Development/Mission to Sri Lanka
 - Mr. William Jennings, Acting Chief Private Sector Development
 - Mr. Vajira Kulatilake, Project Officer

- Securities and Exchange Commission of Sri Lanka
 - Mr. Arittha Wikramanayake, Director General

- Colombo Stock Exchange
 - Mr. V. Kailasapillai, Chairman
 - Mr. Rohan Fernando, Manager Listings

- Institute of Chartered Accountants of Sri Lanka
 - Mr. Mohan Abeynaike, President

Unit Trusts

- Commercial Fund Management (Comtrust Equity Fund)
 - Mr. C. Ramachandran, General Manager

- C.K.N. Fund Management (Pyramid Unit Fund)
 - Mr. Jeevaka Weeratunga, Managing Director
- The Unit Trust Management Company (Ceybank Unit Trust)
 - Mr. A. Kathiravelupillai, Executive Director
- National Asset Management Ltd. (National Equity Fund)
 - Mr. N. Dissanayake, General Manager

Underwriters

- Capital Development and Investment Co., Ltd.
 - Mr. Tennyson Rodrigo, Director/General Manager
 - Mr. Sumith Arangala, Assistant General Manager
- National Development Bank
 - Mr. B. Mahadeva, Chairman

Insurance Companies

- CTC Eagle Insurance Co., Ltd.
 - Mr. C. Jayaratne, Deputy Managing Director

- Insurance Corporation of Sri Lanka
 - Mr. S.G. Udalamatta, Chairman
 - Mr. P.P.J. Perera, Deputy General Manager
 - Mr. M. Kandasamy, Deputy General Manager
 - Mr. A.T.G. Fernando, Administrative Officer

- Union Insurance
 - Mr. Hyde Ramanji, Chief Executive Officer

Retirement Funds

- Employees Provident Fund
 - Mr. N.A. Dharmabandua, Executive Director
 - Mr. K.C.M. Gunasekara, Superintendent

- Employees Trust Fund
 - Mr. Sunil G. Wijesinha, Chairman
 - Mr. Paramsothy, General Manager

Merchant Banks

- Merchant Bank of Sri Lanka
 - Mr. Changa J. Samaraweera, Managing Director

- Seylan Merchant Bank
 - Mr. Siri Kulasekera, General Manger
- Vanik, Inc.
 - Mr. Justin Meegoda, President

Investment Trusts

- Ceylon Investments
 - Mr. M.T.L. Fernando, Chairman
- John Keells Holdings
 - Mr. Adjit Gunewardena, Director
- Upali Investment Holdings Limited
 - Mr. R. Murugiah, Managing Director
 - Mr. S.V.S. Ponnampalam, Director

Venture Capital Companies

- C.F Venture Fund Ltd/CF Growth Fund Ltd.
 - Mr. Manohan Nanayakkara, Chief Executive Officer
- NDB Venture Investments (Private) Limited
 - Mr. W. Kalansuriya, Chief Executive Officer

- Lanka Ventures Limited
 - Mr. J. M. Alles, Chief Executive Officer
 - Mr. Ravi Abeysuruj, Senior Project Analyst

- Equity Investments Lanka, Ltd.
 - Mr. Nihal Wadugodapitiya, General Manager

- People's Venture Investment
 - Mr. Gamini Fernando, Senior Manager

Brokers and Financial Services Companies

- Asia Stock Brokers (Private) Limited
 - Viren Perera, Managing Director
 - Thilan Wijesinghe, Director

- HDF Securities (Private), Ltd.
 - Mr. Anura R. Wickremasinghe, Chief Executive Officer/Managing Director

- Forbes & Walker Stockbrokers
 - Mr. Ravi Peiris, Consultant

- Somerville Stock Brokers (PVT.) Ltd.
 - Mr. Arjuna Dias, Chairman
 - Ms. Shalini Y. Dias, Director

Law Firm

- Julius & Creasy
 - Mr. R. Senathirajah, Partner

STOCK BROKERAGE NEEDS ASSESSMENT

FINANCIAL MARKETS PROJECT TRAINING DEPARTMENT

JULY 14, 1993

The following observations are as a result of time spent at each of the major Stock Brokerage Firms in Colombo. In particular, the Training Specialist, Mr. Seth Isaacs, would like to thank Mr. V.N. Nair of John Keells, Mr. A. Corera of Allied Stock Brokers, A. Kulatunga of Forbes Research and T. Wijesinghe of Asia Stock Brokers for their time and assistance on this project.

I. Operational Needs

As in the United States, the Stock Brokerage Firms in Sri Lanka handle their operational procedures in many different fashions. Unlike in the United States, the Stock Brokerage Firms in Sri Lanka do not always execute their operational procedures.

A. Cashiering

The process of receiving funds for the payment of the purchase of securities, the process of receiving security certificates for deposit into the brokerage account and into the CDS system and the process of remitting funds from the sale of securities need to be streamlined. The security of the cashiering department in the brokerage firms need to be enhanced. Where are the securities which are taken in for deposit held? How long are securities taken in for deposit held in the brokerage office before being physically

transferred out? Is cash being accepted for deposit? Is cash being paid out for withdrawals? If cash transactions are being accepted, where are the funds being kept?

B. Trade Confirmation

The process of customer notification of stocks bought or sold is at times nearly non-existent. Due to the lack of client ID information on the trade tickets of the CSE, brokerage firms are determining trade ownership after the fact. In my opinion, either randomly or through favoritism, this creates the potential for market manipulation. The process of trade confirmation should be done by telephone immediately and by written confirmation to the client posted no later than the close of business, the first business day after trade day. The brokerage firm copy of the trade confirmation must be filed and held for a specific period of time. (In the United States, it's seven years).

C. Monthly Statements

A Monthly Statement must be printed for every account held and delivered in a timely fashion.

D. Trade Corrections

A department whose sole function is to correct or cancel error trades should be established in each brokerage firm. (With the random manner in which trades are

assigned and confirmed, tracing an error trade, and at times even identifying an error trade can be impossible.)

E. Record Keeping

The accurate filing and maintenance of market activity documents such as original trade tickets, trade confirmations, monetary deposit slips, stock certificate deposit slips and customer complaints just to name a few must be held and be retrievable in an orderly fashion. (In the United States, these documents must be presented by the brokerage firm upon demand for a period of seven years).

F. Customer Service Department

It is the suggestion of this writer that a quality customer service department be established at each brokerage firm to handle the requests, complaints and day to day operations of the clients. Such a department can have great impact in minimizing potential problems and maximizing the broker customer relationship.

G. Brokerage Firm Communications with CSE

Most firms have a telephone tie line directly from their office to the trading floor of the CSE. While this system appeared adequate in previous years, the increased volume and market participation can make this mode of communication cumbersome at best. For communications' sake and for the creation of an adequate paper trail, the trades created

in the branch office and executed on the trading floor should be wired (as in the US) or at least faxed from office to trading floor.

II. Sales Support

A. Broker Registration

The stock broker registration program should be strengthened by enhancing the classroom curriculum. An ethics portion to this program should be added. The examination should be updated to show the latest changes to the rules and regulations of the CSE and the SEC.

B. Sales Training

At this time almost all training is centered around rules and regulations and the actual trading of securities. There appears to be no attention paid to the broker client relationship. An extensive sales rules and technique program must be created and incorporated into the broker registration process. In the United States a large portion of the Series 7 revolves around rules governing broker client relationships.

III. Training

- A. A massive training program covering all aspects of the brokerage firm and the financial markets industry is needed. Each employee of the brokerage firms reviewed by this

author is in need of training to increase his knowledge and to support improvement in carrying out his job functions. More importantly, the broker firms themselves are in dire need of corporate training. This training will help define the direction the firm wants to take to achieve its goals and the methods to assist in achieving said goals.

The above document has been written to assist the Financial Markets Project Training Department in ascertaining the needs of the Stock Brokerage Firms in Sri Lanka. This writer has paid special attention to the operational needs, the sales needs and the training needs.